Worldwide Development of Islamic Finance: Trends, Prospects and Challenges

Nazaruddin A. Wahid and Hafas Furqani [1]

Abstract

Islamic banking has developed immensely and has gained global acceptance. From a local system of finance with limited assets and market shares, Islamic banking now emerges as a multinational industry holding assets of around US$ 1.3 trillion (2011) as compared to US$ 6 billion in the early 1980's which represent average annual growth of 17 %. While the prospects for Islamic banking growth continue to be positive, the challenges faced and the opportunity to offer a new financial approach and hence regulation in the international financial landscape is very much awaited. Islamic finance has not only demonstrated its viability and competitiveness in the current environment of a more liberalized and globalized financial system with changing business and technological climates, but now, it is also in the move towards integration into global financial market. The paper attempts to observe the development of Islamic finance worldwide by looking at the history, trends and prospects. The paper also discusses some challenges faced by Islamic financial industry for future progress and development.

Keywords: Islamic Banking, Islamic Finance, Inter-linkages, Intermediation, International Financial Services Industry, Development.

1. Introduction

Islamic banking and finance which emerged in the last four decades has developed immensely and has gained global acceptance. Islamic banking had its debut in 1970s, when the Islamic Development Bank (IDB) as a multilateral development financing institution and the Dubai Islamic Bank (first Islamic commercial bank) were established and mandated to operate in adherence to Sharīʿah rules and principles. Islamic banking has made

[1] Prof. Dr. Nazaruddin A. Wahid is Dean, Faculty of Sharīʿah, IAIN Ar-Raniry, Banda Aceh, Indonesia. Email: nazaruddinaw@yahoo.com

Dr. Hafas Furqani is a Researcher at International Sharīʿah Research Academy (ISRA) for Islamic Finance & Lecturer, IAIN Ar-Raniry, Banda Aceh, Indonesia. Email: hafasf@gmail.com

significant progress worldwide, particularly in South-East Asia, the GCC region, the Middle East and South Asia.

From a local system of finance with limited assets and market share, Islamic banking now emerges as a global industry. Based on *the World Islamic Banking Competitiveness Report 2011-2012*, global Islamic banking assets reached to USD 1.1 trillion in 2012. The global gross *takāful* contributions that reached USD 7 billion in 2009, continued to boast healthy growth to reach USD 12 billion in 2011. *The Zawya Ṣukūk Monitor* reported that the Global *Ṣukūk* issuance in 2012 increased to USD 140 billion from just USD 52 billion in 2010.

The amazing size and scale of Islamic finance industry are now such that no conventional financial institutions would ignore the role it may play in the modern financial world. In line with the hope from the people of the world to the 'alternative' in global financial system, Islamic finance is largely viewed as that alternative and is currently expanding beyond the Muslim countries. The number of conventional financial institutions that are offering Islamic products and creating specialized Islamic subsidiaries is mushrooming worldwide. Foreign-based banks, finance companies, merchant banks, and discount houses are actively seeking to offer Islamic finance services as alternatives to conventional services.

This paper is to discuss the development of Islamic banking worldwide, evaluating its achievements so far, and addressing the opportunities and challenges in the current phase of internationalization of Islamic banking and finance.

2. Islamic Financial System: Approaches of Transformation

Islamic finance in general is perceived as having similar functions as of conventional finance that is intermediation between the surplus of funds and the deficit of funds sectors. Therefore, the definitions of Islamic finance offered by Muslim scholars are not radically or fundamentally different from the conventional finance definition, except the prohibition of interest and gambling, especially on its role and function. The differences are on the "operational" side whereby Islamic finance is operationalized based on Sharī'ah principles and the "objectives" whereby Islamic finance aims at realizing Islamic objectives which are broader rather than merely to gain profit on the basis of interest as in conventional banking practice.[2]

[2] For instance, Ahmad (1994: 11) defines Islamic banking as "to conduct banking operations in consonance with Islamic teachings." Jarhi and Iqbal (2001: 23) define

In other words, in doing business in channeling the fund, Islamic finance has different philosophical foundations based on the teaching of Sharī'ah, such as prohibiting *riba* (usury / interest), *gharar* (uncertainty), *maisir* (gambling) and following the Islamic norms and guidelines. *Riba* is prohibited because in Islam money must not be made from money. Money must be put into productive use in order to create real value that would justify the profit for owner of the money. It must be used as exchange medium and not as a commodity to be traded for itself. Profit, in Islam can only be made if an investment yields real economic value and not based on speculative (bubble) value.

By this philosophical foundation, perspectives and mechanism in financial operation, it is argued that Islamic financial system is superior to the conventional financial system in the sense that it is more stable and promotes growth of real economic sectors as speculative practices on financial instruments are eliminated. At the same time, Islamic finance provides a viable means for Muslims to save, invest and obtain financing in conformity with the Sharī'ah requirements (Khan, 1986; Darrat, 1988).

However, Muslim countries are having different perspectives to the current phenomena between totally rejecting the conventional practice of banking and finance and setting up a fully Islamic financial system on the one hand; or to adopt a dual financial system whereby Islamic finance is set up in parallel with the conventional system. Although it has been recognized that the financial intermediary practice in the sense of channeling fund from the resource surplus to the deficit sectors has been practiced in the history of Islam when Muslim led the world civilization in the middle ages, the current banking and finance, which is being practised in the most of Muslim countries worldwide, is modern creation established and developed by the West in the Western values and frameworks.

In responding the phenomena, two approaches are prevalent: the total and gradual approaches. Iran (1983) and Sudan (1984) have adopted the strategy of complete conversion of their banking systems into totally Sharī'ah-compliant ones, leaving no place for conventional banking and finance. Pakistan also started total transformation in early eighties, but changed policy to parallel functioning of the both systems since 2002 (Janjua, 2003 and 2004; Chapters on Islamisation).

Islamic bank as "a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest."

Iran started to nationalize and restructure its banking system after 1979 revolution. The 37 pre-revolution institutions were merged to six commercial banks (Bank Refah, Bank Melli Iran, Bank Saderat, Bank Tejarat, Bank Mellat and Bank Sepah) and three specialized institutions (Bank Keshavarzi, Bank Maskan and Bank Sanat wa Maadan). The structure of Iran's banking system was reorganized to conform to the principles of Islam, which prohibits payment of *riba*. The Islamic banking system in Iran is codified in 1983 in the Usury-Free Banking Law (Economist Intelligence Unit, 2006: 44.

Sudan attempted to Islamize the entire banking system in 1984 when a presidential decree was issued directing all commercial banks to stop interest based dealings with immediate effect and to negotiate the conversion of their existing interest bearing deposits and advances into Islamically acceptable forms. However, foreign transactions were allowed to be continued on the basis of interest for the time being (Ahmad, 1994: 39-40). After a slow progress during the first decade, since 1992 the financial sector in Sudan is built entirely on Islamic principles and any financial transaction that is not compatible to Sharī'ah is not allowed (Hussein and Omran, 2003: 4).

Pakistan, as indicated above, chose in 2002 to adopt the dual banking and finance strategy to avoid any serious repercussions of entire transformation of financial sector. As part of this process, the State Bank of Pakistan (SBP) has introduced various policies. In December 1999, the Supreme Court's decision on *riba* was announced that required all the banks to transform according to the Islamic modes. But the Government got reviewed the judgment from the Supreme Court and announced criterion for establishment of Islamic banks to work within the conventional system. In September 2002, an amendment in the Sec 23 of BCO 1962 was promulgated in order to promote Islamic banking through establishment of Islamic banking subsidiaries. SBP issued policies for the promotion of the Islamic banking on January 1, 2003 defining criteria for establishment of Islamic banks in the private sector, Islamic banking subsidiaries and standalone branches by conventional banks. The policies encompass the eligibility conditions, licensing requirements, and guidelines on the physical set up along with Sharī'ah compliance and other operational matters of the banks (Janjua, 2003 and State Bank of Pakistan, 2003).

The full-fledged Islamic banking system which is set up under Islamic monetary system is an attempt by such Muslim countries that have experienced revolution in their countries, to free their nations from over-

dependence on the Western monetary system and at the same time challenge Western system with a new alternative believed to be better and just vis-a-vis the conventional one which is described as unjust and exploitative especially to the third world nations.

On the other hand, majority of Muslim countries choose to face the phenomena cautiously. Islamic financial system, although claimed to be better and superior, is still new and has not proven its strength and applicability. Adopting simplistic approach to release themselves from the current dominant financial system and move totally to the new system might not be appropriate and could some how affect the country's economy severely. Therefore, they developed dual financial system, whereby Islamic banking co-exists alongside conventional banking. They adopt a gradual approach with adequate theoretical backgrounds so that it did not create any fiscal, monetary and regulatory problems.

Majority of Muslim countries from the Gulf Cooperation Council region, South Asia, Middle East, South East Asia and some Africa countries preferred to adopt the gradual approach in their effort of Islamization of banking and financial system. In this framework, Islamic financial services are offered through three types of governance structures: (1) Full-fledged Islamic banks either newly licensed or converted from conventional banks; (2) Islamic subsidiaries of conventional banking group; and (3) Islamic banking windows within conventional banks.

For Islamic banking windows and subsidiaries, the overriding regulatory concern has been the prevention of any mixing of Sharīʻah-compliant and non-compliant income that could create confidence issues, leading to fund withdrawals. Hence, such windows and subsidiaries have to comply with firewall requirements, including separate capital for the two types of banking services in some countries.

3. Internationalisation of Islamic Banking and Finance

The landmark of Islamic banking development was the establishment of IDB on October 20, 1975. IDB is an International Islamic bank established by several Muslim countries with the main objectives of fostering economic development and social progress of member countries and Muslim communities in non-member countries in accordance with the principles of Sharīʻah (Ahmed Mohammed Ali, 2002).

Currently Islamic banking has spread massively in at least 75 countries of the world. The evolution of Islamic banking development is considered immense. Islamic banking, in our observation, has been evolving through

five stages of development starting from the notion and conceptual phase in 1960's to internationalization phase in 2005.

3.1. Prior to 1960s and in the 1960s: The Notion and Conceptual Phase

Prior to 1960s and in the 1960s, Muslim scholars had been criticizing the existence of interest based banking system introduced by the Western colonialism in the Muslim countries. The idea to establish a bank based on Sharīʻah principles actually started to emerge in 1890s when Barclays Bank started its Cairo branch to process the financial transactions related to the construction of the Suez Canal. This was the first commercial bank established in the Muslim world. Muslim scholars at that time initiated the critique of bank interest as *riba*. Shaikh Muhammad ʻAbduh as well as Muhammad Rashid Rida had flexible approach on the issue (Shinsuke, 2012).

During 1900–1950 The critique also spread to other Arab regions, and to Indian sub-continent. In this debate, the majority of scholars subscribed to the position that interest in all its forms constitutes the prohibited *riba*. Intellectual effort was also put to offer Sharīʻah compliant theoretical models of banking and finance as a substitute for interest-based banking (IRTI, 2005).

In the 1960s, the effort to put banking and finance based on Islamic principles in practice began in Egypt and Malaysia. In 1963, an Egyptian banker named Ahmad al-Najjar opened a tiny savings bank based on profit sharing instead of lending in the town of Mit Ghamr. The bank was not called Islamic bank since the Nasser government frowned on anything that smacked of Islamism. In 1962, Malaysia established Tabung Haji Malaysia as an institution offering Islamic Financial Services (IFS) that manages the pilgrimage to Makkah for *ḥaj*. Tabung Haji has since flourished and has become the oldest Islamic financial institution in modern times. During 1960s the operational mechanisms for institutions offering Islamic financial services began to be proposed and a number of books/articles published as an intellectual back-up on the viability of Islamic banking based on profit and loss sharing and leasing.[3]

[3] See Siddiqi (1981), for a comprehensive survey of literature on Islamic economics, banking and finance.

3.2. 1970s: The Formative Phase

A decade later, in the 1970's, conceptual discussions of the viability of Islamic banking turned into a practical discussion of how can Muslims replace (conventional) financial practices (deemed to be usury/*riba*-based) with Islamic alternatives. The first attempt was by the establishment of first full-fledged Islamic banking in the world namely Dubai Islamic Bank which started its operation in 1975. In the following years, a number of Islamic banks were established and concentrated mainly in the Middle East such as Faisal Islamic Bank in Egypt (1977), Faisal Islamic Bank in Jordan (1978), Bank of Islamic Finance and Investment in Jordan (1978), Bahrain Islamic Bank (1979), Islamic Investment Company Ltd. in UAE (1979) and others.

In the intellectual sphere, this decade also showed a growing academic consensus among Muslim scholars on the need to have a distinct discipline of Islamic economics as well as a distinct Islamic banking system. The first International Conference on Islamic Economics in Makkah in 1976 attended by numerous scholars around Muslim world played a significant role in initiating the formal discussion in the academic sphere of various topics of applicability, operational, and development of Islamic banking system worldwide.

3.3. 1980s: The Development Phase

In the 1980s, the numbers of Islamic banks and academic institutions emerged in several countries. Iran (1983), Sudan (1984), and Pakistan (1985) announced their intention to transform their overall financial systems so as to be totally in compliance with the Sharīʻah rules and principles. Some countries, like Malaysia initiated to operationalize the first Islamic bank within the framework of the existing system in 1984 with the establishment of Bank Islam Malaysia Berhad (BIMB).

In this decade, a number of Muslim countries started to codify Islamic banking act as the legal foundation for operation of Islamic banking within country's monetary system. Another important milestone in Islamic banking development in the 1980's was the establishment of Islamic Research and Training Institute (IRTI) by IDB in 1981. IRTI is a research institution on Islamic economics, banking and finances that intensively conducts research and spreads the knowledge about Islamic economics and Islamic finance operations worldwide.

3.4. 1990s: The Maturity Phase

In the 1990s public policy interest in the Islamic financial system grew in several Muslim countries. Malaysia set up its second full-fledged Islamic bank in 1992, Bank Muamalat Malaysia Berhad; Brunei Darussalam established its first Islamic bank, Islamic Bank of Brunei in 1993 and Indonesia set up its first Islamic bank, Bank Muʿāmalāt Indonesia (BMI) in 1993. As of 1997, according to the Association of Islamic Banks, there were around 29% of Islamic banks in South Asia, 20% in Africa, 18% in South East Asia, 15% in the Middle East, 12% in the GCC countries, 5% in Europe and America with the total size of assets at 395 million US$ (Archer & Ahmed, 2003).

In this decade, the development of Islamic banking products intensified in order to be able to compete with conventional banking. In addition, there was a growing attraction shown by Western international banks to involve in the industry by offering Islamic financial products. A number of international players such as Dresdner Kleinwort Benson (1995), Citi Islamic Investment Bank (CIIB) (1996), ANZ Group Ltd (1996), ABN Amro (1996), and HSBC Amānah (1998) started to open Islamic windows or Islamic subsidiaries in the Muslim world.

Another important milestone in Islamic banking development is the establishment of the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 1991 to develop accounting, auditing and Sharīʿah standards for adoption with regard to Shariah matters and financial reporting and auditing by Islamic financial institutions.

3.5. 2000 – 2010: The Internationalization Stage

In 2000–2010 the development of Islamic banking system gained momentum by the emergence of various infrastructural institutions of Islamic finance, such as the General Council for Islamic Banks and Financial Institutions (CIBAFI) in 2001, the Islamic Financial Services Board (IFSB) in 2002, the International Islamic Financial Market (IIFM) in 2002, the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI) in 2005, as well as other commercial support institutions such as the International Islamic Rating Agency (IIRA) in 2002, and the Liquidity Management Centre (LMC) in 2002. These institutions provided support to standardize regulation and supervision and facilitated Islamic banking and finance in pursuing soundness, stability and integrity.

During these years, Islamic banking and finance increasingly integrated with the international financial market. Islamic banking which was a ‘local phenomenon’ of particular Muslim countries with a limited market share become an area of ‘international interest’ for both Muslim and Non-Muslim players due to its strength and promising business opportunity in the future. The growing sizes, fast paced growth, and the potential impact on the international financial markets are believed to be the main factors for this development (El-Hawary *e.t al.*, 2004).

Islamic banking and finance is now an established industry sector in the world and the governments in Muslim countries consider it as an industry of the future that cannot be neglected for country’s economic development. Islamic finance can serve as an engine for growth. With this bright prospect, Islamic banking is widely spread in South Asia, Sout East Asia, Middle East, Africa, and recently in some of Western countries. As observed by Zety Akhtar Aziz, Governor of Central Bank of Malaysia (2004), this rapid financial globalization of Islamic finance is result of participation of both the ‘authorities’ and the ‘private sectors’ that prevail in many Muslim countries. In the case of the former, attention has been given to developing the financial infrastructure, including the financial markets, institutions and agencies as well as establishing the necessary prudential and accounting standards, while the latter includes the clientele, i.e. savers, investors and institutions that participate in the process.

4. Future Development: Opportunities and Challenges

4.1. Interaction of the Western and Muslim World

The strong growth of Islamic finance industry, its impact on financial markets as well as its relative resilience to the 2008 crisis has prompted a number of conventional local and international financial institutions to seek stronger relationships and joint project financing arrangements with their Islamic counterparts. While some might apprehensively link Islamic finance to financing the terrorists and extremists (Barber, 2011: 4); most of the people of the world of finance look at it in a positive way as a solid alternative to the conventional financial system. There is an impressive development of Islamic finance and the curiosity towards it is growing in both the Muslim and Western world; it may not be wrong to say that Islamic finance could play a role in facilitating dialogue and interaction between the Muslim world and the West.

In general, the growing interest shown by conventional financial institutions in the Islamic finance industry has been driven by the following phenomena:

First, commercial gain: The conventional financial institutions have come to recognize that the pool of assets controlled by Muslim individuals, institutions and companies is too large for them to ignore. In addition, the global Muslim population is so large that any financial institution overlooking its demand will be missing out a substantial amount of business. Specifically, they recently recognized the rising demand for Islamic financial instruments arises from a growing Muslim population in European countries. Further, the trade links between Muslim and non-Muslim societies are getting closer especially after the petrodollar oil boom in the 1970s. This promising figure, in the long term is believed to increase the profitability of business and may add value for the stakeholders. In addition to that, Islamic banking and finance is the fastest growing segment of the credit market in Muslim countries which is believed to be permanent business phenomenon with an increasing market share in the future. Hence, the keenness and demand for Islamic banking services are too big to ignore by the players of the industries. Islamic banking currently is becoming more popular with the regional and international customers, who are attracted by the flexibility of its financing packages and the growing competitiveness of its products.

The second attraction of Islamic finance is that it is considered as a new alternative. The emergence of Islamic banking and finance as a system of thought and practice is timely in the midst of the world crisis and uncertain solutions to solve the crisis. Islamic banking and finance is viewed as a 'systemic' response to the crises of the capitalist financial system by restructuring the financial and banking system of the world on alternate foundations. The Islamic financial system is expected to respond to the present adverse situation of the world and its unfair financial system, which is exploitative, discriminatory and unjust in its allocation of resources. It is structured to systematically transfer wealth from the poor people to the rich people and from poor countries to rich countries. Conventional finance is also unstable, having fragile foundations that lead to bubble growth and a steady stream of attendant crises. Robertson (1998: 54) articulated these concerns thus: "People are increasingly experiencing the workings of the money, banking and financial system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control."

In this endeavor, efforts are directed to transforming the financial and banking system, and ultimately the whole economy, so that they conform to the Islamic spirit, principles and objectives. The concern is not merely to secure the narrow legal compliance of banking and finance practices but

a more substantive movement toward a good financial system enshrining Islamic values and principles. Ahmad (1999: 14-15) characterizes such an agenda as a shift from a purely pecuniary and hedonistic profit-taking economy to a gainful economy that is also characterized by ethical norms and social commitments as enshrined by Islam.

The increasing number of Western conventional banks establishing Islamic banks, on the other hand, shows that Muslim society especially Islamic bankers do not see the growing involvement of [Western] conventional banks as a competitive threat; instead they are welcoming them for at least three reasons (Moore, 1997: 48):

First, the involvement in the industry of some of the world's biggest and most experienced banks is an emphatic endorsement of the "viability" of the Islamic banking system not only as a new way in doing finance, but a new alternative in financial system.

Second, in the era of global interaction and integration, Islamic bankers welcome the increased commitment of foreign banks to the industry because of an awareness that it will help in the critical area of product development, overcoming the shortcomings commonly found in conventional financial system, and developing new practices and standards.

Third, The increasing number of local and international conventional banks to offer Islamic financial contracts through Islamic windows and the establishment of separate banks, branches, or subsidiaries specializing in Islamic financial products as well as issuing *╥ukuk* is believed to contribute further to the growth of market share in the local and international banking industries that at the end could contribute to the development of Muslim nations.

4.2. Global Outlook of Islamic Finance Industry

Islamic financial system has tremendous potential and prospect in the economic world. The successful operation of Islamic finance in banking, *takāful*, *╥ukuk* and Islamic funds worldwide has established the fact that a financial practice without interest is not only feasible but also profitable.

At present, looking at the trend in responding to Islamic finance, the world can be classified into four types (Grewal, 2012):

1) Countries wherein Islamic finance has a well-established roots and becomes the part of the country's mainstream financial, legal and regulatory systems;

2) Countries wherein Islamic finance having a niche presence, enjoying facilities and having a bright prospects to become mainstream in country's financial system;

3) Countries that welcome the presence of Islamic finance and in the march of engaging with the regulators to pave the way for a better establishment of Islamic finance institutions in the country;

4) Countries that still wait and see on the global development of Islamic finance, its potential and impact to the country's economy. These countries are still in the stage of 'conceptual exploration' to the presence and establishment of Islamic finance. They have yet to explore the possibility of having Islamic financial operations.

While the response of the global community with regard to Islamic finance is diverse, and hence the levels of development in various countries are different, the outlook for the Islamic finance industry in the world looks bright as can be seen in the Table 1:

Table 1: Global Islamic Finance Assets, 2011 (USD Billion)

	Banking Assets	*Ṣukūk* Outstanding	Islamic Funds	*Takāful* Assets	Total Assets
MENA	462.6	0.1	0.5	6.0	469.2
GCC	411.1	55.6	27.1	6.4	500.2
Asia	144.8	120.8	16.2	2.4	284.2
Sub Saharan Africa	14.5	0.2	1.5	0.4	16.6
Others (North America & Europe)	42.9	1.5	14.6	0.0	59.1
Total Assets	1,075.9	178.2	59.9	15.2	1,329.2

Source: KFH Research, 2012

Islamic banking is the fastest growing segment within the Islamic financial market which represents 80.9% of Islamic finance assets worldwide. Iran and Saudi Arabia share the largest portion of global Islamic banking assets at 39.7% and 13.7% respectively. This is followed by Malaysia (9.8%), UAE (9.1%) and Kuwait (9.0%), while other

countries account for below than 5% of global Islamic banking assets. *Ṣukūk* market is the second largest asset class within the Islamic finance industry, accounting for 13.5% of global Islamic finance assets. South East Asia (SEA) still dominates the ╥*ukuk* issuance, followed by GCC, while the Middle East Northern Africa (MENA) market has been slowly increasing its market share.

The global Islamic funds management industry also shows significant trend whereby it charted a 3.5% growth in 2011 with total amount of USD60 billion. The contribution largely comes from equities (46.9%), money market (22.2%), mixed assets (11.8%), real estate (9.0%), ╥*ukuk* (5.8%), commodities (3.4%), trade finance (0.1%), and structured products (0.1%). The global *takāful* industry demonstrated a strong growth rate of 22.9% (contributions at USD13.7 billion) in 2010 as compared to previous years (in 2009 growth rate stood at 17.7% with total contributions value of USD11.1 billion).

In term of business opportunity, the above statistics reveal that Islamic finance industry is a growing segment that cannot be neglected by the players of global finance and by any government of Muslim countries trying to boost their economies. Malaysia, Pakistan, and Bahrain are among the countries that are actively developing Islamic financial system and are in competition to become the Islamic financial hubs that would attract many investors around the world for their facilities and advance financial infrastructures.

4.3. Challenges of Islamic Finance

In general, Islamic finance is expected to grow further at global level. Nevertheless, there are challenges faced by Islamic banks and financial institutions especially for increasing the penetration of financial services, like improving access to financial services and enhancing the level of social inclusion for more than 1.2 billion worldwide Muslim community, challenges related to the effective regulation, supervision and sound corporate governance, and how to inter-link the Islamic banking institutions worldwide so that more contributions can be provided to the development of Muslim countries (Wafik Graiss, 2004, Al-Omar & Abdel-Haq, 1996).

The first challenge pertains to access to Islamic financial services. Islamic finance has the role to channel the funds from surplus unit to deficit unit. A smooth access to Islamic financial services contributes to economic growth. Wafik Grais (2004) exposes three fact observations

about relationship between financial development and economic development. (1) Many observations concluded that an effective financial system can make a sizable contribution to national prosperity. (2) In many developing countries, the penetration of financial services remains limited. For example, in Morocco and Yemen, the share of people having a bank account is reported to be less than 20% and 10% respectively. Meanwhile for IDB member countries the national saving rates as a percentage of GDP has fluctuated around 24 percent over 2000-2003, which rose steadily to almost 28 percent in 2005 (IDB annual report 1426H); and (3) Many members of the Muslim community may refrain from accessing conventional financial services in order not to breach their religious beliefs. Accordingly, the limited penetration of financial services could well be due to this attitude, as well as to the limited development of conventional finance, in a number of countries. Combined, these three observations prompt one to ask whether increased availability of Islamic financial services would increase the penetration of financial services, and consequently economic growth and social inclusion. This is a challenge faced by Islamic banking to address especially concerning the Muslim community.[4] A study by Mohaieddin *et. al.*, (2012) recommends that OIC countries need to develop a regulatory and supervisory framework that supports wide financial inclusion based on sound risk management with sufficient consumer protections. During this process, governments and regulators need to take the lead in supporting improvements.

The second challenge is on regulation, supervision and sound corporate governance of Islamic finance as well as regulation on dispute settlement and arbitration. Those aspects are strongly linked to stability, credibility, efficiency and effectiveness in mitigating the risks faced by Islamic finance. Weak internal controls, transparency and disclosures, and other corporate governance systems are important causes of failure of

---

[4] A study by Stijn Claessens and Erik Feijen (2006: 17) concluded three specific problems of limited access to finance in most of the developing countries. The first is due to macroeconomic instability, a weak institutional environment, large unnecessary government intervention, and a lack of competition that can act as barriers to accessing financial services or, even when accessible, make financial services more expensive or incapable of being provided in a viable way. The second is due to supply and demand mismatches. From the supply side, financial services providers often simply do not target the poor and small firms due to problems of information, high transaction costs, and poor enforcement of contracts. From the demand side, poor households and smaller firms often lack financial sophistication and literacy, do not trust financial institutions, simply do not realize their need for financial services, or unserstand that products offered can be ill-suited to their needs. The third is related to the lack of data and research in broadening access to finance.

institutions and financial instability. In addition to that, a common judicial / legal system on Islamic finance needs to be set up. Currently, in absence of any authoritative judicial institutions deciding on the Sharīʻah conformity of a commercial transaction, individual Sharīʻah scholars fill this gap (Sacarcelik, 2012). They interpret Islamic legal principles and exercise oversight of the products and operations of the Islamic finance industry. The unregulated practice would bring no good to the industry in future.

For that reason, the implementation of a cohesive and harmonizing regulatory strategy is important for Islamic finance industry in order to support its growth and enhance its credibility and competitiveness in a global market place (El-Hawary, *et.al*, 2004; IRTI, 2005). The establishment of international organizations and financial infrastructure institutions such as AAOIFI and IFSB to regulate and harmonize the standards in Islamic banking and finance is considered significant that would strengthen the development of Islamic financial institutions. In addition, the gaps between the theory/concept and application of Sharīʻah rules in banking and financial practices within the higher objectives of Sharīʻah (*maqāsid al-Sharīʻah*) is also identified as one of the challenges. Anwar (2002: 4) and Nyaze (2007: 128), for example, contend that the pragmatic approach in developing Islamic banking and finance is not genuine and, hence, offers products that fall within the ambit of *riba*. The shortcoming comes from an inadequate understanding of *riba* in the modern context which allows flexibility and discretion in proposing banking instruments and transactions but with uncertainty as to legal validity, whether they really conform to the Sharīʻah or its spirit (*maqāsid al-Sharīʻah*).

With a continuous effort to develop Sharīʻah related standards at the domestic level and global landscape, we hope the problems could be resolved. In pursuing that effort, the spirit should be more than merely complementing ‘what is missing’ in international financial regulation of Bank for International Settlements – Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS). Effort should also be put in attempting to establish a new practice and regulation by really providing a breakthrough in global financial framework and international standards setting towards creating a robust and solid financial system.

The third challenge, the most important one, since Islamic banking is entering an internalization stage, is how to enhance economic

collaboration and strengthen business linkages in the Muslim world through the integration of Islamic financial market. A strong and vibrant financial system is a precondition to achieving sustainable and balanced economic development (Furqani and Mulyany, 2009). The Islamic financial system is formulated to provide clarity, direction and strategies to develop a global Islamic financial system that will meet the needs and priorities of our respective economies. As developing economies strengthen their trade and investment ties, they must also increase integration of their financial systems. Having more integrated financial systems will enable Muslim countries, in particular, to efficiently channel their large savings into a vast array of investment opportunities both within Muslim countries and across other developing economies (Razak, 2010).

The expansion of inter-linkages of intermediation and markets among Muslim countries would lead to a more efficient allocation of capital and thus enhance the prospects for strengthening further the growth performance. It also offers enhanced opportunities for raising financing and facilitating greater risk diversification. Furthermore, to build a sustainable and progressive domestic Islamic financial system, the key components comprising the Islamic banking industry, Islamic capital markets, the *takāful* market and fund management industry should also develop intensively with the strong linkages, inter-dependence and synergies among these components in the system (Schmit, 2013; Aziz, 2004).

The inter-linkages of Islamic financial markets could be utilized to solve the poverty, inequities, high rates of illiteracy, lack of human capital development and poor infrastructure that prevail in many parts of the Muslim world today. As noted by the former Chairman of OIC, Abdullah Badawi (2005), of the 57 O.I.C. countries, 27 are classified by the World Bank as low-income countries, with per capita income of less than 765 U.S. dollars. At the same time, 21 countries are classified as severely indebted. Some of the Muslim countries are also faced with extremely difficult socio-economic problems and are often forced to rely on international aid and assistance. Islamic banking and finance certainly needs to address these problems by allocating more services and funds.

5. Conclusion

Islamic banking and finance has been successful in creating global awareness and making significant achievements in the international financial markets. Islamic finance now has presented itself as a new alternative in global financial landscape. It has demonstrated the viability and competitiveness in the current environment of a more liberalized and globalized financial system, with changing business and technological environment. As a form of financial intermediation it is now becoming increasingly integrated with the international financial system and persuasively influences the global financial setting.

Islamic finance industry is projected to have a significant growth in the future as many countries have started to offer Islamic financial services and a large number of international financial players have opened their Islamic finance institutions and products around the world.

The immense development of Islamic banking and finance should be seen as a potential source for economic welfare that can lead to economic interaction and integration, income growth reducing thereby the prevalence of poverty in the Muslim countries. The governments of Muslim countries should therefore consider the expansion of Islamic finance industry worldwide as an opportunity to gain economic prosperity for the respective countries. Neglecting this sector may mean that the country has forgone the large pool of funds of Muslim nations around the world.

Integrating the Islamic financial market worldwide that consists of Islamic banking industry, *takāful* market, fund management market and Islamic capital market, is among the challenges that need to be resolved immediately. The international Islamic financial institutions such as AAOIFI, IFSB, CIBAFI, IFIM, LCM, and IICRIE may perform excellent role to make Islamic financial market closer and interlinked, as well as to establish the standards on prudential regulation, supervision and sound corporate governance.

Bibliography / References

1. Abdullah Bin Haji Ahmad Badawi. (2005). *Economic Development Towards A Progressive Ummah,* Keynote address at the seminar on 10-Year Master Plan for the Islamic Financial Services Industry, Putrajaya Marriot, 22 June 2005.

2. Ahmad, Ziauddin. (1994). Islamic Banking: State of the Art. *IDB Prize Winners' Lecture Series No.2.* Jeddah, Saudi Arabia: IRTI.

3. Ahmed Mohammad Ali. (2002-2003). Islamic Development and its Role in Financing Projects. *IAP-SEC Journal,* 43-46.

4. Anwar, Muhammad. (2002). *Islamicity of Banking and Modes of Islamic Banking.* Kuala Lumpur: IIUM Press.

5. Archer, S. & Ahmed, T. (2003). Emerging Standards for Islamic Financial Institutions: The Case of the Accounting & Auditing Organization for Islamic Financial Institutions. *mimeo*, World Bank.

6. Aziz, Zeti Akhtar. (2004). *Towards Creating an Islamic Financial System as an Integral Part of the International Financial System - Strategies and Challenges,* Speech at the Asian Islamic Banking & Finance Summit, KL, 21 September 2004.

7. Aziz, Zeti Akhtar. (2006). *Recent Developments in Islamic Finance in Malaysia,* Keynote address at the Malaysian Islamic Finance Issuers and Investors Forum 2006, Kuala Lumpur, 14 August 2006.

8. Barber, S. (2011). The "New Economy of Terror:" The Financing of Islamist Terrorism. *Global Security Studies, 2* (1), 1-13. Available at http://globalsecuritystudies.com/Barber.pdf

9. Claessens, Stijn., and Feijen, Erik. (2006). *Financial Sector Development and the Millennium Development Goals.* Washington: World Bank.

10. Darrat, A. F. (1988). The Islamic interest-free banking system: some empirical evidence. *Applied Economics,* 20, 417 – 425.

11. Economist Intelligence Unit. (2006). *Country Profile: Iran.* USA: The Economist.

12. El Qorchi, Mohammed. (2005). Islamic Finance Gears Up**.** *Finance & Development 42* (4), 46-49.

13. El-Hawary, Dahlia., Grais, Wafik., and Iqbal, Zamir. (2004). Regulating Islamic Financial Institutions: The Nature of the Regulated. *World Bank Working Paper 3227* (Washington: World Bank).

14. Ernst & Young. (2013). 'The world Islamic banking competitiveness report 2011-2012', Report, available at http://www.zawya.com/newsletterbulletin/quately_╖ukuk_bulletin.cfm?issue=U130115104921

15. Global Research. (2003). *Bahrain Islamic Bank*. Global Investment House: Kuwait. http://www.menafn.com/updates/research_center/Kuwait/Equity_val/global1003.pdf

16. Grais, Wafik. (2004). *Islamic Finance and Penetration of Financial Services*, Keynote Address at the Seminar on Comparative Supervision for Islamic and Conventional Finance, Beirut December 7-8, 2004. http://siteresources.worldbank.org/EXTISLAMF/Resources/WG_Nurul.pdf

17. Grewal, Baljit Kaur. (2012). Introductory Session and GIFF Report. KFH Research presentation at the Global Islamic Finance Forum 2012, 19 September 2012. Available at http://www.giff.com.my/c/document_library/get_file?uuid=2d23edad-32dc-4949-a317-7fc061afbf6e&groupId=11873

18. http://www.ita.doc.gov/td/finance/publications/Islamic_Banking.pdf

19. Hussein, Khaled A. and Omran, M. F. (2003). *Financial Development in Arab Countries*. IRTI, Jeddah, Saudi Arabia.

20. IDB Annual Report 1426H. (2005-2006). Jeddah, Saudi Arabia: IDB. http://www.isdb.org/31Annualreport/chapter-4-1426H.pdf

21. Islamic Research and Training Institute (IRTI). (2005). *Islamic Financial Services Industry Development Ten-Year Framework.* Jeddah, Saudi Arabia: IRTI.

    http://www.sbp.org.pk/ibd/2006/Ten_Year_Master_plan.pdf.

22. Janjua, M. Ashraf (2003 and 2004); "History of the State Bank of Pakistan; (1977-1988) and (1988–2003)" SBP, Karachi.

23. Jarhi, Mabid Ali and Iqbal, Munawar. (2001). Islamic Banking: Answers to Some Frequently Asked Questions. *Occasional Paper No.4.* Jeddah, Saudi Arabia: IRTI.

24. Khan, M. (1986). Islamic Interest Free Banking: A Theoretical Analysis. *International Monetary Fund Staff Papers*, 33, 1-27.

25. Mohieldin, Mahmoud; Iqbal, Zamir; Rostom, Ahmed & Fu, Xiaochen. (2012). The Role of Islamic Finance in Enhancing Financial Inclusion in Organization of Islamic Cooperation (OIC) Countries. Islamic Studies, vol. 20 (2), 55-120.

26. Moore, Philip. (1997). *Islamic Finance: A Partnership for Growth.* London: Euromoney Publications PLC.

27. Nyazee, Imran A. Khan. (2007). The Rules and Definition of Riba. In Nafis A. Siddiqui, Mohd. Zahir and Abu Nazim (eds.), *Riba, Modern*

and Islamic Banking: A Critique (pp. 126-146). India: Mustafa Educational Network Trust.

28. Razak, Najib. (2010). Global Islamic Finance Forum on Islamic Finance: Opportunities for Tomorrow. Available at http://www.1malaysia.com.my/speeches/global-islamic-finance-forum-on-islamic-finance-opportunities-for-tomorrow/
29. Sacarcelik, Osman. (2012). Overcoming the Divergence Gap between Applicable State Law and Sharia Principles: Enhancing Clarity, Predictability and Enforceability in Islamic Finance Transactions Within Secular Jurisdictions. Paper presented at the *8th International Conference on Islamic Economics and Finance*, Qatar. Available at http://www.google.com.my/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCsQFjAA&url=http%3A%2F%2Fconference.qfis.edu.qa%2Fapp%2Fmedia%2F300&ei=d0rNUdDtFcSPrgemh4DIAg&usg=AFQjCNHPKoX6guKk2xtHrVLG7IJBNwd0_g&sig2=buuN5behgdkW6jmPdzGhzg&bvm=bv.48572450,d.bmk
30. Schmit, Scott. (2013). Expanding Trade Financing Opportunities Through Islamic Finance. Report to International Trade Administration. Available at
31. Shinsuke, Nagaoka. (2012). Ciritical Overview of the History of Islamic Economics: Formation, Transformation, and New Horizons. *Asian and Africal Area Studies, 11* (2), 114-136.
32. Siddiqi, Muhammad Nejatullah. (1981). *Muslim Economic Thinking: A Survey of Contemporary Literature.* Jeddah: International Centre for Research in Islamic Economics and the Islamic Foundation.
33. Siddiqi, Muhammad Nejatullah. (2004). *Riba, Bank Interest and the Rationale of Its Prohibition*. Jeddah, Saudi Arabia: IRTI.
34. State Bank of Pakistan. (2003); *Banking System Review for the year ended December 31*, 2003. The State Bank of Pakistan.
35. Zaher, T. & Hassan, K. (2001). A Comparative Literature Survey of Islamic finance and Banking. *Financial Markets, Institutions & Instruments*, Vol. 10, No.4, pp. 155 – 199.

****